Broken Companies or Broken System? Charting the English Insolvency Valuation Framework in Search for Fairness

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ABSTRACT

This paper adopts a normative approach to investigate measurement of value in English insolvency and bankruptcy cases. The valuation techniques are assessed against a revised communitarian, fairness-oriented framework based on a modified version of Rawls, Finch and Radin's social justice concepts of fairness. This paper explains the need for a revised communitarian, fairness-oriented framework to measure value in insolvency. Finally, it investigates if regulatory reforms are needed to improve fair measurement of value in insolvency and bankruptcy procedures.

I. INTRODUCTION

This paper adopts a normative approach to investigate measurement of value in English insolvency and bankruptcy cases. The valuation techniques are assessed against a revised communitarian, fairness-oriented framework based on a modified version of Rawls, Finch and Radin's social justice concepts of fairness. This paper explains the need for a revised communitarian, fairness-oriented framework to measure value in insolvency. Finally, it investigates if regulatory reforms are needed to improve fair measurement of value in insolvency and bankruptcy procedures.

This paper is part of a larger study on fair measurement of value in insolvency. The findings of a documentary analysis on the techniques adopted by English courts to

value assets and businesses are reported in a separate paper.[1] These two papers tackle a similar, broad issue, i.e. the fairness of valuations in insolvency and bankruptcy cases. Where this paper focuses on the fairness of valuation techniques, the second paper mentioned above focuses on the fairness of valuation assessments by the judiciary in English insolvency and bankruptcy cases.

Asking questions about fair value in insolvency is particularly important due to a variety of factors. These include the increased complexity of valuation cases, where intangible assets such as cryptocurrencies[2] and intellectual property rights[3] feature with increasing prominence and frequency. Other factors include the leading role played by office holders (particularly administrators) in insolvency procedures and the risks of conflict of interests with some of the parties involved in these procedures, particularly in pre-packaged sales.[4] Finally, the light-touch supervision

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The author is greatly indebted to *Nikhil Gokani* and *Onyeka Osuji* for their insightful comments on earlier drafts of this paper, and to *Lisa Meller* for her constructive criticism of the manuscript and for her diligent proof-reading of this work. This article covers literature and case law published before 1 September 2019. The usual disclaimer applies.

[1] E Vaccari, 'Broken Companies or Broken System? Promoting Fairness in English Insolvency Valuation Cases' (forthcoming).
[2] Among others, see: *Harding v Bartercard UK ltd* [2017] EWHC 1742 (Ch), [2017] 5 W.L.U.K. 539; *Ang v Reliantco Investments ltd* [2019] EWHC 879 (Comm), [2019] 3 W.L.R. 161.
[3] Among others, see: *VLM Holdings ltd v Ravensworth Digital Services ltd* [2013] EWHC 228 (Ch), [2013] 2 W.L.U.K. 354; *British Sky Broadcasting Group plc v Digital Satellite Warranty Cover ltd (in liq.)* [2012] EWHC 3679 (Ch), [2012] 12 W.L.U.K. 621; *Geolabs ltd v Geo Laboratories* [2012] EWPCC 45, [2012] 8 W.L.U.K. 77; *Fraser v Oystertec plc* [2003] EWHC 2787 (Pat), [2004] B.C.C. 233.
[4] Pre-packaged administrations are arrangements under which the sale of all or part of the company's business or assets is negotiated with a purchaser prior to the filing for administration and the sale is effected immediately on, or shortly after, its commencement.

exercised by courts[5] can also affect the achievement of a fair outcome in insolvency valuation disputes.

Answering questions about fairness in valuation cases can no longer be escaped due to the public concern associated with the use of certain corporate insolvency procedures such as pre-packaged administrations to connected parties[6][7] and company voluntary arrangements ('CVAs') in certain sectors of the economy.[8] Other reasons include the increasing number of valuation disputes.[9] Issues have also been raised by the outcome of some high-profile cases, such as the transfer of *BHS* (2015) from its previous owner to a former racing driver and bankrupt entrepreneur for £1.[10] Another exemplary case is the takeover and rescue attempt of *Debenhams* (2019) by one of its main competitors, *Sports Direct*, which had built up a near 30 percent

[5] Nevertheless, courts do not simply defer to the administrator's business judgment on the basis that it seems rational: *Re Partnership of Isaccs* [2017] EWHC 2405 (Ch), [2018] B.C.C. 551, at [42]; *Re Capitol Films ltd (in admin.)* [2010] EWHC 3223 (Ch), [2010] 12 W.L.U.K. 308; *Re Buckingham International plc (in liq.) (No.2)* [1998] B.C.C. 943; *Re Edennote ltd* [1996] B.C.C. 718.

[6] J Moulton, 'The Uncomfortable Edge of Propriety—Pre-packs or Just Stitch-ups?' (Autumn 2005) Recovery 2; S Davies, 'Pre-pack—He Who Pays the Piper Calls the Tune' (Summer 2006) Recovery 16, 17 (arguing that a small number of professional bad apples tend to operate via pre-packs to facilitate phoenix trading); P Walton, 'Pre-packaged Administration: Trick or Treat?' (2006) 19 Insolv. Int. 113; P Walton, 'Pre-packin' in the UK' (2009) 18 I.I.R. 85; C Umfreville, 'Review of the Pre-Pack Industry Measures: Reconsidering the Connected Party Sale before the Sun Sets' (2018) 31(2) Insolv. Int. 58.

[7] SIP 16 defines "connected party" with reference to s.249 and s.435 of the IA 1986, and art. 4 and 7 of the Insolvency (NI) Order 1986. Directors, shadow directors, associate persons of the debtor, close family members, companies in the same group and anybody with significant prior connection to the debtor fall within the definition of connected party. However, SIP 16 contains a carve out for secured lenders over one third or more of the shares in the insolvent company.

[8] These are mainly hospitality and the retail industry. Prominent CVAs in the hospitality sector include *Giraffe* and *Ed's Easy Diner* (2019), *Gourmet Burger Kitchen* (2019), *Polpo* (2019), *Jaime's* (2018) and *Byron* (2018). Recent CVAs in the retail industry include *Arcadia* (2019), *Debenhams* (2019), *Carpetright* (2018), *Mothercare* (2018) and *Homebase* (2018).

[9] Among others, see: *Philbin v Davies* [2018] EWHC 3472 (Ch), [2018] 6 WLUK 695; *Brewer et al. (as joint liquidators of ARI Digital UK Ltd) v Iqbal* [2019] EWHC 182 (Ch), [2019] P.N.L.R. 15.

[10] S Butler and J Rankin, 'BHS sold for £1 – Sir Philip Green announces disposal of loss-making chain' *The Guardian* (London, 12 March 2015) <https://www.theguardian.com/business/2015/mar/12/sir-philip-green-sells-off-lossmaking-bhs> accessed 11 September 2019.

stake in the department store company when it was clear that the latter was in serious financial troubles.[11] Finally, requests for fairness and flexibility in rescue and turnaround cases are increasingly and consistently coming from the industry itself.[12]

The paper adopts a communitarian, fairness-oriented framework. This framework builds on extensive literature in the area[13] and underpins English corporate insolvency law.[14] Recent policy documents do not depart from this well-established approach.[15] This paper does not consider utilitarian and law and economics perspectives because the key policy document which underpins English corporate insolvency law[16] promotes social considerations and protection of the rights and expectations of vulnerable parties.[17] Social justice considerations and protection of vulnerable parties are not usually considered in utilitarian and law and economics perspectives.

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[11] J Eley, 'Sports Direct considers takeover bid for Debenhams' *The Financial Times* (London, 26 March 2019) <https://www.ft.com/content/aac9c1c2-4f2c-11e9-b401-8d9ef1626294> accessed 11 September 2019.

[12] J Eley, 'JD Sports calls for 'fairness and flexibility' in lease arrangements' *The Financial Times* (London, 10 September 2019) <https://www.ft.com/content/8c83c578-d38e-11e9-8367-807ebd53ab77> accessed 11 September 2019.

[13] See below section II(b) of this paper.

[14] K Cork, *Report of the Insolvency Law Review Committee Insolvency Law & Practice*, Cmnd 8558 (1982), paras 191 – 198.

[15] See the emphasis on improving transparency and accountability, as well as protecting creditors and limiting the impact of corporate failures on customers, suppliers and employees in: Department for Business, Energy and Industrial Strategy, *Insolvency and Corporate Governance. Government Response* (26 August 2018) (i)-(ii) <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/736207/ICG_-_Government_response_doc_-_24_Aug_clean_version__with_Minister_s_photo_and_signature__AC_final.pdf> accessed 11 September 2019.

[16] Cork (n 14).

[17] Ibid, paras 191 – 198.

This paper investigates the structural components of the notion of fairness. The main purposes of this paper are to: (i) determine the elements needed to fairly measure value; and (ii) assess if the existing valuation techniques achieve a fair measurement of value in English insolvency and bankruptcy cases.

The first original contribution of this paper is to offer a specific framework to measure whether assets and businesses are fairly valued in insolvency and bankruptcy cases. This framework can potentially be used in the future to develop insolvency law with coherence and purpose.[18] This communitarian, fairness-oriented framework is based on a modified version of Rawls, Finch and Radin's concepts of fairness. This paper is the first scholarly work to adopt the modified version of these concepts in insolvency.

The works of Finch and Radin (as well as this paper) are premised on Rawl's political conception of justice as fairness.[19] According to Finch, who built on the work of Frug,[20] fairness should consider issues of justice and propensities to respect the interests of affected parties by allowing such parties access to, and respect in, decision and policy processes.[21] This notion of fairness is thus both of procedural and substantive nature. According to Radin, fairness involves acting in the best interests of the parties concerned, while addressing issues of reasonableness, justice and

[18] Other authors have developed frameworks to explain and develop the understanding of this area of law. The most prominent examples in England and Wales are: RJ Mokal, 'The Authentic Consent Model' (2001) Legal. Stud. 400; V Finch and D Milman, *Corporate Insolvency Law: Perspectives and Principles* (3rd edn, CUP 2017).
[19] J Rawls, *Justice as Fairness. A Restatement* (3rd edn, Harvard University Press 2003).
[20] GE Frug, 'The Ideology of Bureaucracy in American Law' (1984) 97(6) Harv. L. Rev. 1276.
[21] Finch and Milman (n 18).

lawfulness, and acting in compliance with the public interest.[22] The modified version of fairness uniquely developed in section II(c) of this paper distinguishes the procedural from the substantive nature of this concept and includes Radin's notion of fairness.

Secondly, this paper uniquely shows that when assessed against the fairness standard adopted in this paper, none of the valuation techniques currently available to English courts is without limitations. Even those valuation techniques that rely on a multitude of indicators, such as the discounted cash-flow method (among others), fail to be intrinsically substantially and procedurally fair.

This paper proceeds as follows. Section II explains more fully why it is important to fairly measure value in insolvency cases. After having discussed prior work on social justice and fairness in insolvency, it introduces the fairness-oriented framework employed in this paper to assess the consistency and appropriateness of the system of judicial valuations under English law. Section III assesses the existing valuation techniques against the proposed fairness-oriented framework. Section IV draws some conclusions, namely that when assessed against the fairness standard adopted in this paper, none of the valuation techniques currently available to the courts and practitioners are without limitations.

[22] M Radin, 'Fair, Feasible and in the Public Interest' (1941) 29(4) Calif. L. Rev. 451, 454-455.

II. IMPORTANCE OF SOCIAL JUSTICE AND FAIRNESS IN INSOLVENCY

There is no generally accepted, standard definition of "social justice".[23] However, according to political theorists[24] and philosophers,[25] social justice is about promoting a set of fair and just relations between individuals and society. As evidenced elsewhere,[26] a seminal concept of social justice theories is their distributive nature,[27] i.e. the idea that power and wealth, resources and opportunities should be distributed within society, among a group of people or classes of people in a just and fair manner.[28] Many experimental studies have demonstrated that fairness considerations are essential in establishing how people handle distributional conflicts,[29] but the concept of fairness in distribution is hard to define.[30]

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[23] DD Raphael, *Concepts of Justice* (OUP 2001).

[24] B Barry, *Theories of Justice* (Harvester-Wheatsheaf 1989); IM Young, *Justice and the Politics of Difference* (Princeton University Press 1990); D Miller, *Principles of Social Justice* (Harvard University Press 1999); B Barry, *Why Social Justice Matters* (Polity 2005).

[25] These include Plato in *The Republic* (Global Classics 2017), Aristotle in *Politics* (2nd edn, University of Chicago Press 2013) and *The Nicomachian Ethics* (University of Chicago Press 2011), T Aquinas in *The Summa Theologica* and J Rawls, *A Theory of Justice* (Harvard university Press 1971).

[26] A Fejos, 'Social Justice in EU Financial Consumer Law' (2019) 24(1) Tilburg L. Rev. 68.

[27] S Fleishaker, *A Short History of Distributive Justice* (Harvard University Press 2004).

[28] M Reisch, 'Defining Social Justice in a Socially Unjust World' (2002) 83(4) Families in Society 343; B Jackson, 'The Conceptual History of Social Justice' (2005) 3(3) Political Studies Review 356; S Duffy, 'The Citizenship Theory of Social Justice: Exploring the Meaning of Personalisation for Social Workers' (2010) 24(3) Journal of Social Work Practice 253; W Duff and others, 'Social Justice Impact of Archives: A Preliminary Investigation' (2010) 13 Archival Science 317, 321.

[29] E Hoffman and others, 'Preferences, Property Rights and Anonymity in Bargaining Games' (1994) 7(3) Games Econom. Behav. 346; TL Cherry and others, 'Hardnose the Dictator' (2002) 92(4) Amer. Econ. Rev. 1218; N Frohlich and others, 'Modeling Other Regarding Preferences and an Experimental Test' (2004) 119(1-2) Public Choice 91; S Gächter and A Rield, 'Moral property Rights in Bargaining with Infeasible Claims' (2005) 51(2) Management Sci. 249; AW Cappelen and others, 'Just Luck: An Experimental Study of Risk Taking and Fairness' (2013) 103(3) Amer. Econ. Rev. 1398; AW Cappelen and others, 'Fairness in Bankruptcies: An Experimental Study' (2019) 65(6) Management Sci. 2832.

[30] I Mevorach, 'Equitable Distribution and Accountability' in I Mevorach, *Insolvency within Multinational Enterprise Groups* (OUP 2009) (arguing that insolvency law should be concerned with fairness in distribution without giving a definition of this concept).

However, not all commentators agree on this limited account of the concept of social justice. It has, therefore, been argued that social justice looks towards attending to the needs of individual citizens.[31] It is about individual human beings, not simply the redistribution of economic outputs. This view of social justice has emerged in the late twentieth century and is adopted in this paper. Social justice is understood as 'examining the underlying institutions and the dynamics between the privileged and disadvantaged, between the elite and the rest of the society'[32] with a view to correcting inequalities and promoting values such as inclusivity[33] and fairness.[34]

While social justice theories have been subject to extensive criticism,[35] there is an undeniable interest in them in insolvency law. A significant portion of the scholarship in the field – the so called "communitarian approach" – is influenced by social justice tenets. The communitarian approach is discussed later in this section.

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[31] This idea was first introduced by Hegel: GWF Hegel, *Philosophy of Right* (OUP, 1967).

[32] S Haeffele and V Henry Storr, 'Is Social Justice a Mirage?' (2019) 24(1) The Independent Review 145, 146.

[33] DR Korobkin, 'Contractarianism and the Normative Foundations of Bankruptcy Law' (1992) 71 Tex. L. Rev. 541, 572 (arguing that this would be one of the principles, alongside rational planning, that the parties affected by the debtor's financial distress would choose to put as the foundations of insolvency law).

[34] RJ Mokal, 'On Fairness and Efficiency' (2003) 66 M.L.R. 452; S Paterson, 'Debt Restructuring and Notions of Fairness' (LSE Research Paper 2017) 2 <http://eprints.lse.ac.uk/68559/1/Debt_restructuring_author.pdf> accessed 11 September 2019.

[35] FA Hayek, 'The Mirage of Social Justice' (vol. 2) in *Law, Legislation and Liberty: A New Statement of the Liberal Principles of Justice and Political Economy* (University of Chicago Press 1976) 62 and 78 (rejecting the very idea of social justice as meaningless, religious, self-contradictory, and ideological, in believing that to realize any degree of social justice is unfeasible, and that the attempt to do so must destroy all liberty); T Sowell, *The Quest for Cosmic Justice* (Free Press 1999); Miller (n 24); Rawls (n 25).

There is a consensus that social justice can be relied on only when it stands on legitimate principles.[36] One of the most authoritative and pivotal concepts of all social justice theories is "fairness".[37] Fairness is not a value plucked from the sky, but a notion which would be endorsed by parties of different cultural, social and political persuasions.[38] However, it might prove difficult to agree on the precise terms and boundaries of this concept.

As stated in the introduction, policy documents in England and Wales have long recognised and recently reinstated the significance of social justice principles in insolvency cases. However, why should we promote social justice values in general, and fairness in particular, in insolvency law? Who has discussed social justice approaches in this field and on what values have discussions focused so far?

This section addresses first the "why" question, i.e. the reasons for promoting social justice values in insolvency. Then, it carries out a literature review of the theoretical approaches to insolvency, with a particular focus on communitarian frameworks, to identify the values which have been discussed and promoted so far. Finally, this section suggests a revised communitarian, fairness-oriented framework based on a modified version of Rawls, Finch and Radin's concepts of procedural and substantive fairness. It is argued that this revised framework is better equipped to deal with the adoption of social justice approaches in insolvency law.

[36] RM Whaples, 'New Thinking about Social Justice' (2019) 24(1) The Independent Review 5, 7.
[37] Rawls (n 19).
[38] Finch and Milman (n 18) 45.

II(a). Social Justice in Insolvency: Why?

Modern English insolvency law is based on the work of the Cork Committee, a group of experts chaired by Kenneth Cork and commissioned by the Labour government in 1977. Their duty was to review, examine and make recommendations about the law and practice relating to insolvency, bankruptcy, liquidation and receivership. The final Report published in 1982[39] included a comprehensive list of objectives. These goals encompassed, among others, the need to ensure that proceeds arising from the sale of the debtor's assets or business are distributed *fairly* and *equitably* among creditors.[40] The Cork Committee also stressed that insolvency procedures should be administered *honestly* and *competently* for the interests of all the interested parties.[41]

Since the publication of the Report, these goals have been largely endorsed not only by academics[42] but also by the government.[43] Subsequent reforms, including the Insolvency Act 1986 ('IA 1986') and the Enterprise Act 2002 ('EA 2002'), are largely premised on Cork's recommendations.[44] Recent consultations for proposals of

[39] Cork (n 14).
[40] Ibid, objective (e).
[41] Ibid, objective (f).
[42] R Goode, *Principles of Corporate Insolvency Law* (5th edn, Sweet & Maxwell 2018).
[43] Department of Trade and Industry, *A Revised framework for Insolvency Law* (Cmnd 8175, 1984).
[44] Finch and Milman (n 18) 16 (showing that recent reforms, including the EA 2002, are premised on the Cork's suggestions of managing insolvency risks proactively and for the benefit of a large range of stakeholders).

reform also seek views on how to improve the system while maintaining 'a fair balance of interests for all stakeholders'.[45]

All these initiatives suggest that fairness-oriented approaches ought to address the significant inequality of power and position of the parties affected by the debtor's insolvency. To evaluate whether this assumption can stand, it is necessary to examine the position of creditors in more detail.

Creditors are some of the most prominent parties that can be interested and affected by the debtor's insolvency but – by far – they are not the only ones. A creditor supplies services or goods to the debtor without requiring immediate payment. This is usually known as a trade creditor. However, a creditor can also be a lender who offers money to a debtor in exchange of equity or on the promise of higher returns by means of interests (institutional lenders). Employees themselves are also creditors of the company for which they work, until their salary and pension funds have been fully paid by their employer.

Some creditors may reduce their loan risks by obtaining privileged claims to repayment should the company file for insolvency or the debtor for bankruptcy. Security can arise either consensually - by means of a pledge, a contractual lien, a mortgage or an equitable charge - or through the operation of law, for instance if the creditor retains possession of the debtor's assets until full payment is made.

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[45] Department for Business, Energy & Industrial Strategy, *Insolvency and Corporate Governance* (20 March 2018) 5 <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/691857/Condoc_-_Insolvency_and_Corporate_Governance_FINAL_.pdf> accessed 11 September 2019.

While it is acknowledged that the broadest differentiating criterion in English law is between secured and unsecured creditors, not all unsecured parties are unsophisticated creditors or lack any effective remedies in case of the debtor's failure to repay their loan. Even in the absence of full, registered securities, parties can enter into a broad range of arrangements[46] which are not strictly speaking securities but have a similar economic effect. Generally speaking, it is only sophisticated creditors who are able to negotiate any of these protections in their negotiations with the debtor.

Frequently, however, creditors lack this power and/or the expertise and knowledge to enter into any of these arrangements with the debtor. Sometimes it is also the nature of the business (e.g. sale-and-supply agreements, utility contracts, etc.), which prevents an otherwise experienced party from including these clauses in their agreements.

Creditors, therefore, can be either sophisticated or not, either secured or not. They can also be voluntary or involuntary, meaning that some parties may not choose to deal with the debtor and yet they may have a compensation right protected by law if the debtor becomes insolvent or bankrupt. This is the case, for instance, of tort claimants and victims of environmental harm.

[46] These include guarantees and indemnities, comfort letters, set-off clauses, nettings clauses, retention of title arrangements, etc.

The unequal bargaining power of different creditors results in significantly different levels of protection for creditors' rights in insolvency, particularly in the valuation process carried out during formal insolvency procedures.

Secured creditors can take assets out of the company and out of the reach of creditors in formal insolvency and bankruptcy procedures. Additionally, they are the first to be paid out of the insolvency estate and they may have rights to appoint an office holder.

Some of the non-contractually protected creditors may be otherwise protected by the law. This is the case for privileged creditors such as the employees[47] and (in the near future) the government for certain taxes.[48] It is also the case for pension debts[49] and certain claims for services and goods provided by the creditors or the office holders after the commencement of the insolvency procedure.[50] Unsecured creditors are also collectively entitled to a "prescribed part" of the company's property which is subject to a floating charge.[51] Insiders such as directors and key creditors may orchestrate pre-packaged sales of the distressed business, frequently to connected

[47] Depending on the individual situations, employees can apply to the government for redundancy payment, holiday pay, outstanding payments such as unpaid wages, overtime and commission and money earned during their notice period. Some of this money is given priority in distribution over other unsecured creditors: see s.386 IA 1986 and Sch. 6, para.9-12 IA 1986.
[48] The government announced that it is planning to extend joint and several liabilities to directors, company officers and other relevant parties involved in tax avoidance, evasion or phoenixism where there is a risk that the company may deliberately enter insolvency, to act as a deterrent for non-compliance with tax rules: HMRC, *Tax Abuse and Insolvency: A Discussion Document – Summary of Responses* (7 November 2018) 7 <https://www.gov.uk/government/consultations/tax-abuse-and-insolvency> accessed 11 September 2019.
[49] Para.8, Sch. B1 IA 1986.
[50] Para.99, Sch. B1 IA 1986.
[51] S.176A IA 1986.

parties, in order to preserve the going concern value of the business and – frequently – their jobs.

As argued, the system is not *per se* just and fair. The consequences of unbalanced bargaining powers are likely to result in detrimental treatment for selected interested parties in formal insolvency procedures. Any deviations from the principle of equal treatment of creditors should, therefore, be grounded on solid, theoretical bases to be justified in the law. The social justice tenets of fairness and equity can justify these asymmetries in the powers of the interested parties. As a result, social justice issues, and particularly fairness issues, feature and ought to feature prominently in insolvency.

II(b). Social Justice in Insolvency: Who Cares? What for?

In order to fully appreciate the contribution of this paper to legal scholarship and to understand where this paper fits in, it is useful to sketch out the scholarly debate on social justice values in insolvency law.

Differences among interested parties may justify the need for fairness but tell us nothing about what fairness truly is. This sub-section, therefore, discusses how the existing theoretical frameworks that either do not or marginally rely on social justice

tenets (contractualist and contractarian theories)[52] or are heavily influenced by them (communitarian, multi-value approaches)[53] interpret the concept of fairness in insolvency. This section, consequently, focuses on the distributive rationales suggested by the different visions of corporate insolvency law.

Contractualist, neo-libertarian commentators[54] suggest treating corporate insolvency rules as private law remedies. Based on economic analysis, they maintain that private negotiations should be preferred, from a standpoint of efficiency, over compulsory statutory rules. Furthermore, they uphold that the heuristics currently favoured by academics to justify insolvency law principles and purposes fall short of a satisfactory explanation for the autonomy of this area of law. They reject, therefore, any call for compulsory distributive rules in insolvency. The view that corporate

[52] "Contractualist" scholars are neo-libertarian commentators who suggest treating corporate insolvency rules as private law remedies. Major contributors to this line of thinking include RA Epstein, *Simple Rules for a Complex World* (Harvard University Press: Cambridge, MA, 1995); DG Baird, 'A World Without Bankruptcy' (1987) 50(2) Law & Contemp. Probs. 173 (arguing that living in a world without bankruptcy or any similar collective procedure is not as far-fetched or ridiculous as it might appear at first glance); BE Adler, 'A World Without Debt' (1994) 72 Wash. U. L.Q. 811 (who built upon Baird's reasoning to argue that it is possible to give away not only with bankruptcy, but also with debt); A Schwartz, 'A Contract Theory Approach to Business Bankruptcy' (1998) 107(6) Yale L.J. 1807 (contending that the only mandatory rules in an insolvency system should be structural and that insolvency laws exist only to increase efficiency by solving the creditors' coordination problem). "Contractarian" and "proceduralist" are the very same word used by Baird to define those academics (as himself) who resist the inclusion of separate (re)distributive goals in insolvency law. An outcome, on the contrary, advocated by "traditionalist" or "communitarian" scholars: DG Baird, 'Bankruptcy's Uncontested Axioms' (1998) 108 Yale L.J. 573. See also: MG Shanker, 'The Abuse and Use of Federal Bankruptcy Power' (Fall 1975) 26(3) Case W. Res. L. Rev. 3 (who believed that rules valid only in front of bankruptcy courts are a tension-creating situation); TH Jackson, 'Bankruptcy, Non-Bankruptcy Entitlement, and the Creditor's Bargain' (1982) 91 Yale L.J. 857 (who argued that insolvency law should deal only with inter-creditor questions on the basis of the creditors' bargain model).

[53] For a distinction between these two terms, see below in this section of the paper.

[54] See above ftn 52.

insolvency law should mainly enforce but not create rights[55] and preserve their relative value[56] is shared by contractarian scholars.[57] Insolvency courts should simply determine the existence of these rights (but not create new ones) if these rights are challenged in the course of an insolvency procedure.[58]

For the reasons explained in sub-section II(a) of this paper, this line of thinking is not and cannot be persuasive: social justice issues arise in any insolvency case. Overlooking fairness and equitable issues does not seem the most appropriate course of action and, certainly, it is not the course of action advocated by this paper. The reliance on economics-derived notions such as efficiency and the principle of general average make contractarian visions unsuitable to address the social justice issues of fairness and equality among creditors. For instance, while involuntary claimants have distinctive rights against the insolvent estate, their specificity and uniqueness are not appreciated by contractarian standards.

Some contractarians[59] have broadened their views to include considerations of fairness and justice. Korobkin, for instance, argues that justice in insolvency situations is a matter of distribution of influence over strategies and actions of the

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[55] *Cambridge Gas Transport v Official Committee of Unsecured Creditors of Navigator Holding plc* [2006] UKPC 26, [2007] 1 AC 508 [15].
[56] TH Jackson, *The Logic and Limits of Bankruptcy Law* (2nd edn, Harvard University Press 2001) 27.
[57] Shanker (n 52) (arguing that rules valid only in front of bankruptcy courts are a tension-creating situation); Jackson (n 52); RE Scott, 'Through Bankruptcy with the Creditors' Bargain Heuristic' (Spring 1986) 53(2) U. Chi. L. Rev. 690; TH Jackson and RE Scott, 'On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain' (1989) 75 Vand. L. Rev. 155; Baird, 'Uncontested Axioms' (N 52); BE Adler, 'The Law of Last Resort' (2002) 55(6) Vand. L. Rev. 1661.
[58] *Re Lines Bros (in liq.)* [1983] Ch. 1, (CA).
[59] Rawls (n 25); Korobkin (n 33); Mokal (n 18).

distressed corporation.[60] Mokal, furthermore, argues that justice is about the distribution of rights in the insolvent company's assets.[61] However, these scholars fail to provide clear guidance on the co-ordination between contractarian and value-oriented approaches.

Unlike contractualists, contractarians advocate for a mandatory system of insolvency law. The insolvency framework is conceived as a collectivised debt collection device.[62] Insolvency law is needed because it is the most appropriate way to respond to the common pool problem created when diverse co-owners assert rights against a common pool of assets.[63] Insolvency law should pursue the maximisation of return to creditors[64] subject to the constraints consistent with the rationale for having laws of insolvency.[65] According to these authors, broad concerns about business failures and social welfare should be addressed by non-insolvency laws.[66]

The lack of justification for distributional goals – that are, nevertheless, present in any insolvency law, as evidenced in the previous sub-section of this paper – brought

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[60] Korobkin (n 33) 570-571.
[61] Mokal (n 18) 435.
[62] B Xie, *Comparative Insolvency Law: The Pre-pack Approach in Corporate Rescue* (Edward Elgar Publishing 2016); DG Baird and TH Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy' (1984) U. Chi. L. Rev. 97, 106.
[63] Jackson (n 56) chs. 1 and 2.
[64] Jackson (n 56); Baird and Jackson (n 62); TH Jackson, 'Translating Assets and Liabilities to Bankruptcy Forum' (Jan. 1985) 14(1) J. Leg. Stud. 73; DG Baird, 'The Uneasy Case for Corporate Reorganizations' (Jan. 1986) 15(1) J. Leg. Stud. 127; DG Baird and TH Jackson, 'Bargaining After the Fall and the Contours of the Absolute Priority Rule' (1988) 55 U. Chi. L. Rev. 738; Jackson and Scott (n 57).
[65] CW Mooney, 'A Normative Theory of Bankruptcy Law: Bankruptcy as (is) Civil Procedure' (2004) 61 Wash. & Lee L. Rev. 931.
[66] Baird and Jackson (n 62) 103.

some contractarian commentators to expand their framework by incorporating a "common disaster" component to explain and justify the existence of some distributional goals in insolvency law.[67] The "common disaster vision" is based upon the "general average rule" conceived in the field of the law of admiralty. Its premise is that the managers of a company in financial distress share a lot of similarities with the captain of a ship facing a shipwreck. Like the captain, the manager is the agent of all parties participating in the venture. When the perilous situation arises, it is in the interest of all participants that the captain/manager takes all interests equally into account.

Similarities with the law of admiralty suggest when it is possible to depart from pre-bankruptcy entitlements. This should occur when: (1) an imminent common danger exists; (2) part of the cargo or the company must be jettisoned to attempt saving the remainder; and (3) the attempt to avoid the common peril should look - from an *ex-ante* perspective - more likely than not to succeed.[68] From this perspective (later supported even by the proponents of the original version of the creditors' bargain model),[69] risk sharing and general average contribution are justified in insolvency only if they 'improve the prospects for a successful reorganization and increase the

[67] Scott (57); Jackson and Scott (n 57).
[68] This vision is justified by reference to the principle of general average, conceived in the field of the law of admiralty. According to it, when the ship is on the brink of disaster (shipwreck), the captain ceases being the main purveyor of the employer's priorities and tries to adopt the best possible course of action to save the boat, the goods and the life at stake (or at least as much as possible of them).
[69] Jackson and Scott (n 57).

value of the enterprise whenever going-concern value exceeds the value of a piecemeal liquidation'.[70]

Finally, alongside with team production theories,[71] communitarian scholars[72] submit that (corporate) insolvency law should be understood as an autonomous set of rules, capable of treating with fairness and justice the honest but unfortunate debtors, who are no longer capable of paying their debts as they fall due, and of 'weighing the interests of a broad range of constituents'.[73] Warren, for example, identifies four principal goals of the insolvency system: '(1) to enhance the value of the failing debtor; (2) to distribute value according to multiple normative principles; (3) to internalize the costs of the business failure to the parties dealing with the debtor; and (4) to create reliance on private monitoring'.[74] Other scholars argue that the central policy justification of insolvency law is to cope with default in an integrated system.[75]

These values and theories, however, have been criticised for vagueness, uncertainty and indeterminacy.[76] Despite their intended goals, communitarian theories fail to reach socially just outcomes as they try to promote several conflicting values and

[70] Scott (n 57) 704.
[71] LM LoPucki, 'A Team Production Theory of Bankruptcy Reorganization' (2004) 57(3) Vand. L. Rev. 741.
[72] Among others: K Gross, *Failure and Forgiveness: Rebalancing the Bankruptcy System* (Yale University Press 1997); E Warren, 'Bankruptcy Policy' (Summer 1987) 54(3) U. Chi. L. Rev. 775; DR Korobkin, 'Rehabilitating Values: A Jurisprudence of Bankruptcy' (May 1991) 91(4) Col. L. Rev. 717 in the U.S.; Finch and Milman (n 18) in the U.K.
[73] Finch and Milman (n 18) 35.
[74] E Warren, 'Bankruptcy Policymaking in an Imperfect World' (Nov. 1993) 92(2) Mich. L. Rev. 336, 344.
[75] Gross (n 72).
[76] G McCormack, *Corporate Rescue Law – An Anglo-American Perspective* (Edward Elgar 2008) 35.

principles at the same time, without offering a hierarchy among them or principles to address these conflicts.[77] The theories also fail to distinguish between substantive and procedural goals.[78]

There have also been authors that have provided an analytical framework for the fairness debate in debt restructuring. Finch, for example, suggests that insolvency law could be explained and developed against four basic concepts or benchmarks: efficiency, expertise, accountability and fairness.[79] Her effort is certainly praiseworthy, as her monograph represents the first attempt in the English jurisdiction to provide a theoretical analysis and critique of insolvency law.[80] However, the decision to rely on four conflicting values resulted in problems of co-ordination among them. Like other contractarian scholars, she fails to offer a hierarchy between these benchmarks and to distinguish between procedural and substantive goals. Also, her approach can further be criticised because she 'does not reveal the principles governing [the benchmarks], nor the factors which distinguish them from each other'.[81] Finally, Finch does not 'provide a statement of her conception of fairness, let alone a defence of her theory of it'.[82]

[77] R Bork, *Principles of Cross-Border Insolvency Law* (Intersentia 2017); G Moss, 'Principles of EU Insolvency Law' (2015) 28 Insolv. Int. 40.
[78] Mokal (n 34).
[79] Finch and Milman (n 18) 41; V Finch, 'The Measures of Insolvency Law' (1997) 17(2) Oxford J. Legal. Stud. 227.
[80] Mokal (n 34) 467.
[81] Ibid 462.
[82] Ibid 463.

Paterson explores the quality of fairness in debt restructuring and conceives different (substantive) principles of fairness and procedural factors to determine whether the outcome of the case was fair.[83] The problem with her approach is that the author does not go far enough. She does not offer arguments to justify whether fairness should prevail over other considerations, thus being subject to the same critical voice as other communitarian scholars.

Finally, Crystal and Mokal offer a conceptual framework for the valuation of distressed companies.[84] The focus of their articles is on warning of the potential, strategic and structural factors that impinge on the value of the debtor and on providing guidance to courts when carrying out valuations of financially distressed businesses. The authors, however, do not offer benchmarks or values to guide all interested parties (including judges) through the valuation process.

This literature review, therefore, shows that the existing visions of insolvency law fail to provide a persuasive justification for social justice approaches to insolvency. They either suggest the inclusion of too many, conflicting principles (communitarian and related approaches, Finch and Paterson) or they overlook the importance of the social justice narrative in insolvency (contractarian and contractualist visions, Crystal and Mokal).

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[83] Paterson (n 34) 3.

[84] M Crystal and RJ Mokal, 'The Valuation of Distressed Companies – A Conceptual Framework' (2006) 3 Int. C.R.: Part I vol. 3(2), 63; Part II vol. 3(3), 123.

Sub-section II(a) suggested that the key social justice concept that comes into consideration in insolvency cases is substantive (equality) and procedural fairness. The next sub-section, therefore, suggests a specific framework of social justice in insolvency based on the concept of "fairness".

II(c). Fairness-oriented Framework of Social Justice in Insolvency

The literature review carried out in the previous sub-section shows that, so far, there is no developed theoretical understanding of the social justice concept of procedural and substantive fairness in insolvency and bankruptcy law.

However, not every unlawful treatment is unfair and not every differential treatment between the parties should be labelled as unfair. Additionally, some discriminatory treatments may be unfair because parties have no comparable rights in the same process or procedure and the law does not give the same powers to exercise their substantive rights (procedural unfairness) to each of the interested parties.[85] Other imbalances are simply associated with the rights recognised to the parties and their consistency with the overarching goal of the system (substantive unfairness).

In any case, pursuant to the communitarian tradition, it is appropriate for insolvency law to establish a set of rules and principles that treat the parties affected by the

[85] Procedural goals are understood in this paper as how the law goes about attaining its substantive goals. Substantive goals are the ends that the law seeks to pursue: see Mokal (n 34) 457.

debtor's failure with justice and fairness. Adopting a clear definition of fairness has significant practical consequences. In the absence of a clear definition of fairness, situations cannot be properly differentiated from each other, and regulatory recommendations for "improving" the system may lack solid underpinnings.[86] Policy mistakes may arise if our unscrutinised instincts are given an unconditional, final say.[87]

This sub-section, therefore, suggests a specific framework to understand whether assets and businesses are fairly valued, in a procedural and substantive manner, in insolvency and bankruptcy cases. The proposed framework is communitarian, but it differs from other communitarian approaches in some key aspects: (i) it relies only on one rather than multiple values, thus setting it apart from Finch's approach; and (ii) it offers a reasonably specific definition of the key value (fairness) in its dual dimension, procedural and substantive, thus setting it apart from Warren's arguments in *Bankruptcy Policy*.[88]

It may be the case that such approach may not find favour with some "traditional" contractarian and communitarian scholars. The contractarians may complain about the lack of efficiency considerations, while the latter may criticise the proposed framework as being too simple to deal with otherwise complex issues. In reply to contractarian criticisms, it is submitted that the notion of procedural fairness offered

[86] Mokal (n 34) 2.
[87] A Sen, *The Idea of Justice* (Penguin Books 2010) 51.
[88] Warren (n 72).

below includes considerations of efficiency. With reference to communitarian objections, it can be pointed out that the proposed framework is not designed to explain the goals of the insolvency system. It only provides the rationale underpinning valuation practices in formal insolvency and bankruptcy scenarios.

Under this fairness-oriented approach, the notion of "fairness" is adapted from Rawls, Finch and Radin. The most fundamental characteristics of the political conception of justice as fairness have been outlined by Rawls. In his view, this concept should be applicable to the structure of political and social institutions[89] and transform liberal societies in a fair system of co-operation. It should offer a framework of thought within which issues are to be approached and settled,[90] 'situate free and equal persons fairly and […] not permit some to have unfair bargaining advantages over others'.[91]

Rawls' conceptualisation is particularly appealing for this paper because it offers a comprehensive liberal outlook, while its acceptance does not presuppose any particular comprehensive view.[92] Yet, there is the need to specify how the concept of fairness would work in the insolvency law context. For that purpose, it is pertinent to refer to the work of other scholars, Finch and Radin.

As mentioned at the beginning of this paper, Finch posits that fairness should consider issues of substantive justice and distribution, as well as the propensities to

[89] Rawls (n 19) 12.
[90] Ibid 12 (idea of a well-ordered society).
[91] Ibid 15 (idea of the original position).
[92] Ibid 33.

respect the interests of affected parties by allowing such parties access to decision and policy processes.[93] Radin argues that fairness involves the best interests of the parties concerned, issues of reasonableness, justice and lawfulness, and compliance with the public interest.[94]

Both definitions of fairness lack determinacy as they fail to provide a criterion that can be used by courts and practitioners in valuation procedures. In addition, Finch's definition is built on studies by Stokes, Frug and others aimed at legitimating the interference of public powers with public interests and private rights.[95] Her definition of fairness was conceived as one of the four benchmarks (alongside efficiency, accountability and expertise) in constructing a framework to explain the nature and justify the purpose of insolvency law. In this paper, the notion of fairness is not used to legitimise corporate power or to discuss the aims of insolvency law. It is used to provide a theoretical basis to avoid an arbitrary use of the autonomy of the parties in insolvency procedures. This calls for a more precise and detailed notion for the specific, fairness-oriented framework discussed in this paper.

In insolvency, one of the dominant normative concerns should be the extent to which the insolvency framework can address substantive and procedural unfairness among creditors. This can be done by reducing the ability of insiders to (unfairly) protect themselves from the consequences of insolvency and by reducing the right of

[93] Finch and Milman (18).
[94] Radin (n 22) 454-455.
[95] M Stokes, 'Company Law and Legal Theory' in W Twining 9ed), *Legal Theory and Common Law* (Blackwell 1986); B Sutton (ed), *The Legitimate Corporation* (Blackwell 1993); Frug (n 20).

some creditors to (unfairly) claim a ransom position.[96] As a result, it is submitted that procedural fairness is the propensity of the system to rely on replicable and competitive techniques to value assets and to allow interested parties to challenge decisions taken in the course of insolvency procedures. Substantive fairness is the propensity of the system to adjudicate in favour of the parties who have a lawful interest under the law whenever valuation decisions do not take the best interests of the parties concerned, the peculiarities of the valued assets, business or the market, the claimant-defendant relationship into reasonable account or do not treat similar situations alike. Issues of substantive unfairness come into consideration when there is an imbalance between the risk assumed by the parties before and after insolvency, or if the claimants have not given *authentic* consent to the position in which they now find themselves.

Fairness has substantive, not simply procedural aspects. Pursuant to social justice theories, fairness can represent the only or – at least – the main goal of insolvency law and can prevail over other policy considerations.[97] As a result, fairness requires that the interested parties are capable of obtaining adequate protection when the decisions taken by the insolvency office holders fail to consider the parties' competing interests and to act accordingly, i.e. to promote the best interests of creditors. The notion of an interested party includes, as remembered at the

[96] Mokal (n 34) 38.
[97] Mokal (n 34) 457.

beginning of this paper, any creditors and shareholders who have realistic prospects of receiving a distribution of assets or proceeds in foreseeable circumstances.

This enhanced, procedural and substantive notion of fairness is used in the remaining parts of this paper to assess if the existing statutory and judicial approach to measurement of value in insolvency ensures the protection of the rights of the interested parties in accordance with the differences in their status, bargaining power and protection under the law.

II(d). Summary

Where company law manages the process of legitimating corporate managerial power, insolvency law should make things fair and just for the parties affected by the debtor's failure. Creditors, insolvency practitioners ('IPs') and courts take a leading role in formal insolvency procedures in promoting socially just values. Fairness has been actively promoted as an autonomous value of English insolvency law, particularly on measurement and valuation issues, where issues of inequalities between different categories of creditors may lead to unfair treatment of those claimants in a weaker position.

Differences among interested parties may justify the need for fairness but tell us nothing about what fairness truly is. This paper offers an enhanced, procedural and substantive notion of fairness. It suggests using this notion as the cornerstone

element of a revised communitarian framework to understand whether assets and businesses are fairly valued in insolvency and bankruptcy cases. It is now pertinent to assess the existing valuation techniques against the proposed fairness-oriented framework.

III. MEASURING FAIR VALUE IN INSOLVENCY

The rise of the new economy[98] and the widespread use of intangible assets[99] raise issues of valuation,[100] traditionally considered one of the most vexing aspects of any insolvency procedure.[101]

Valuation is the process of inferring the value that a relevant community places on an asset or a group of them.[102] Valuations are prepared upon constancy in the economic environment. They require reliable and consistent financial information, as

[98] M Castells, *The Rise of the Network Society: The Information Age* (Blackwell Publishers 1996); B Jessop, 'Post-Fordism and the State' in B Greve (ed), *Comparative Welfare Systems* (Macmillan 1996); P Aghion and P Howitt, 'A Model of Growth Through Creative Destruction' (1992) 60(2) Econometrica 323; RE Lucas, 'Making a Miracle' (1993) 61(2) Econometrica 251; B Lev, *Intangibles* (23 July 2018) 2 <https://ssrn.com/abstract=3218586> accessed 11 September 2019.
Not all commentators agree on the distinction between old and new economy. For instance, then Federal Reserve Chairman Alan Greenspan, in what came to be known in the global financial markets as "the Berkeley Speech", said that the economy could be labelled as "new" only if there had 'been a profound and fundamental alteration in the way [the] economy works that creates discontinuity from the past and promises a significantly higher path of growth': A Greenspan, 'Is There a New Economy?' (1998) 41(1) Calif. Manag. Rev. 74, 75. Greenspan refused to give a final answer to that question, but observed that human psychology and the way in which it affects the market had not significantly changed from the past.
[99] J Haskel and S Westlake, *Capitalism without Capital: The rise of the Intangible Economy* (Princeton University Press 2018) 21. For a definition, see: JA Cohen, *Intangible Assets: Valuation and Economic Benefit* (Wiley 2005).
[100] S Mason, 'Putting a Price on Intellectual Property' (Aut. 2011) Recovery 24.
[101] E Warren, 'A Theory of Absolute Priority' (1991) Ann. Surv. Am. L. 9, 13.
[102] AJ Casey and J Simon-Kerr, 'A Simple Theory of Complex Valuation' (2015) 113 Mich. L. Rev. 1175.

well as stable financial structures. Ideally, valuations are undertaken against comparable businesses or transactions, which are therefore used as benchmarks.[103]

In insolvency scenarios (but the same principles apply to personal bankruptcy proceedings), valuation is essential 'to identify the debtor's fulcrum security creditors'[104] and to determine if the insolvent estate has received a reasonably equivalent value for the company's and debtor's assets. However, in any valuation, the outcome is dependent on the technique used to assess the value of the debtor. Reliance on the liquidation or sale price of the asset rather than on the going concern value of the business or the contribution that the asset makes to the purchaser affects the measurement of value. Additionally, 'the appreciation of value by each stakeholder is dependent on the information which they have and when they have it'.[105]

There are methods that have the potential of being more easily and fully compliant with the definition of fairness adopted in this paper than others. This section, therefore, investigates the most commonly accepted valuation methodologies to assess their degree of compliance with the definition of fairness adopted in sub-section II(c) of this paper.

[103] D Wilton, 'Valuation Issues in the UK Distressed Environment' (2010) 3(6) C.R. & I. 227, 228-229.
[104] PM Gilhuly and others, 'The Price is Right – or is It? US and UK Valuation Methodologies in Bankruptcy' (2013) 6(2) C.R. & I. 59, 59.
[105] Wilton (n 103) 227.

III(a). Measuring Value in Insolvency

The problem of legal valuation is well known, but the debate in England has developed later than in the United States,[106] where courts and scholars have long investigated this issue as part of the U.S. Code requirements to confirm Chapter 11 plans over parties' objections ("cram-down"). In England, with few noticeable exceptions,[107] the debate has been built on the findings of U.S. literature[108] or as a reaction to seminal cases,[109] such as *IMO Car Wash*.[110] This is because much of the

[106] WJ Blum, 'The Law and Language of Corporate Reorganization' (1950) 17 U. Chi. L. Rev. 565; S Levmore, 'Self-Assessed Valuation Systems for Tort and Other Law' (1982) 68 Va. L. Rev. 771; MJ Roe, 'Bankruptcy and Debt: A New Model for Corporate Reorganization' (1983) 83 Colum. L. Rev. 527; LA Bebchuk, 'A New Approach to Corporate Reorganizations' (1988) 101(4) Harv. L. Rev. 775; CP Bowers, 'Courts, Contracts, and the Appropriate Discount Rate: A Quick Fix for the Legal Lottery' (1996) 63 U. Chi. L. Rev. 1099; BE Adler and I Ayres, 'A Dilution Mechanism for Valuing Corporations in Bankruptcy' (2001) 111 Yale L.J. 83; LA Bebchuk and JM Fried, 'A New Approach to Valuing Secured Claims in Bankruptcy' (2001) 114 Harv. L. Rev. 2386; DR Fischel, 'Market Evidence in Corporate Law' (2002) 69 U. Chi. L. Rev. 941; DG Baird and DS Bernstein, 'Enterprise Valuation and the Puzzling Persistence of Relative Priority Outcomes in Corporate Reorganizations' (2004) <https://escholarship.org/uc/item/0z7906ct> accessed 28 June 2019; LA Fennell, 'Revealing Options' (2005) 118 Harv. L. Rev. 1399; K O'Rourke, 'Valuation Uncertainty in Chapter 11 Reorganizations' (2005) Colum. Bus. L. Rev. 403; DG Baird and DS Bernstein, 'Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain' (2006) 115 Yale L.J. 1930; K Shafman, 'Contractual Valuation Mechanisms and Corporate Law' (2007) 2(1) Va. L. & Bus. Rev. 53; CS Sontchi, 'Valuation Methodologies: A Judge's View' (2012) 20 Am. Bankr. Inst. L. Rev. 1; MT Roberts, 'The Bankruptcy Discount: Profiting at the Expense of Others in Chapter 11' (2013) 21 Am. Bankr. Inst. L. Rev. 157; PM Lopez and others, 'Valuation of the Professional Sports Franchise in Bankruptcy: It's a Whole Different Ballgame' (2014) 18 Lewis & Clark L. Rev. 299; Casey and Simon-Kerr (n 102); K Ayotte and ER Morrison, 'Valuation Disputes in Corporate Bankruptcy' (2018) U. Pa. L. Rev. 1819.

[107] Crystal and Mokal (n 84); S Paterson, 'The Adaptive Capacity of Markets and Convergence in Law: UK High Yield Issuers, US Investors and Insolvency Law' (2015) 78(3) M.L.R. 431; S Paterson, 'Market Organisation and Institutions in America and England: Valuation in Corporate Bankruptcy' (2018) 93 Chi.-Kent L. Rev. 801.

[108] Gilhuly and others (n 104).

[109] P Hemming, 'The Real Story of a Business' (Win. 2014) Recovery 23.

[110] *Re Bluebrook ltd (aka IMO Carwash)* [2009] EWHC 2114 (Ch) [2010] B.C.C. 209. See also: EW Purcell and A Boyce, 'The Courts Speak on Valuation in Restructurings: IMO Car Wash, SAS and Wind Hellas lessons' (2010) 7(2) Int. C.R. 129; Wilton (n 103).

valuation debate in England and Europe takes place in private or unreported proceedings.[111]

No common approaches have been implemented to deal with these matters. While the discounted cash-flow ('DCF') method is frequently used by American courts,[112] it is not infrequent for U.S. judges to rely on multiple valuation methods to determine a debtor's value range.[113] It has been authoritatively argued in a comprehensive and well-referenced paper that English courts sidestep this problem by allowing debt-for-equity swaps whenever it is proven that creditors would have received less if no reorganisation had been agreed ('liquidation method').[114] However, recent cases show that, like their American colleagues, English judges rely on multiple valuation methods to determine the valuation range of the debtor.[115] These methods, however, do not consistently make reference to social justice values and, particularly, to fairness issues.

[111] Gilhuly and others (n 104) 62.
[112] Alongside with CCM and CTM methods: O'Rourke (n 106); Gilhuly and others (n 104) 59.
[113] *Re Iridium Operating LLC*, 373 B.R. 283, 344 (Bankr. S.D.N.Y. 2007); *Re DBSD North America, Inc.,* 419 B.R. 179 (Bankr. S.D.N.Y. 2009); *Re Chemtura Corp.*, 439 B.R. 561 (Bankr. S.D.N.Y. 2010); *Re Spansion, Inc.*, (426 B.R. 114 (Bankr. D. Del. 2010); *Re PTL Holdings LLC*, 2011 WL 5509031 (Bankr. D. Del. Nov. 10, 2011) (pre-packaged Chapter 11 plan).
[114] Paterson (n 107) 801.
[115] *Bluebrook* (n 110); *Saltri III ltd v MD Mezzanine SA SICAR* [2012] EWHC 3025 (Comm); [2013] 1 All E.R. (Comm).

III(b). Valuation Techniques in Corporate Insolvency Cases

While the basis of valuation is often strongly debated, valuation follows the same fundamentals for both distressed and healthy businesses.[116] It is carried out by professional valuers and it is premised on one of the techniques discussed below.

In corporate insolvencies, actual valuation ('AV') refers to the going concern value of the company or the market price of the assets. This is usually done by testing how much bidders would be able to offer for the distressed debtor. Valuers adopt a multiple market approach ('MMA') capitalised by appropriate risk-adjusted rates to determine the future performance of the subject company.[117] The capitalisation rate is generated by looking at companies traded in public markets. This affects the relevance of this rate for small and medium enterprises. Additionally, in depressed markets, AV may lead to over-compensate secured creditors at the expense of unsecured ones. Furthermore, even in competitive markets, AV may be affected by asymmetric information among investors, temporary illiquidity of prospective purchasers, strategic behaviour of the leading creditors, etc.

From a fairness standpoint, AV methods are procedurally fair because they ensure replicability of results and reliance on competitive procedures such as auctions to determine the valuation price of the assets. However, a mechanistic use of these methods fails to take the substantive side of the fairness paradigm into proper

[116] EW Purcell, 'Distressed Valuation' (2009) 6(17) Int. C.R. 17; G Smith and D King, 'How Insolvency Practitioners Value a Business' (2015) 28(2) Insolv. Int. 20, 21.
[117] Purcell (n 116) 17.

consideration. The price that a party is willing to pay at an auction is not necessarily the fair price of the asset, for instance because the sale took place in a period of the year when demand is traditionally low.[118]

AV seems to represent the approach preferred by English courts,[119] according to which 'the best indication of the value of an asset *at any particular time* is what someone will pay for it after reasonable attempts had been made to sell it'.[120] In *Ludsin*, the court reached such a conclusion despite the fact that other expert valuations (commissioned by the same debtor) attributed a much higher value to the property[121] and irrespective of the harm that actual valuation could cause to junior creditors.[122]

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[118] *Philbin* (n 9).

[119] *Bluebrook* (n 110). See also: *Re Hawk Insurance Co ltd* [2001] EWCA Civ 241; [2002] B.C.C. 300; *Re Telewest Communications Plc (No. 1)* [2004] EWHC 924 (Ch); [2004] B.C.C. 342. Against: *Re MyTravel Group Plc* [2004] EWHC 2741 (Ch), [2005] 1 W.L.R. 2365; and [2004] EWCA Civ 1734, [2004] 12 WLUK 456, where the courts adopted a liquidation approach. See also: P Ellis and E Dusic, 'Method of Valuing Company's Assets in a Scheme of Arrangement' (2009) 22(10) Insolv. Int. 157.

[120] *Ludsin Overseas ltd v Douglas John Maggs* [2014] EWHC 3566 (Ch), [2014] 10 WLUK 893, [23] (emphasis added). For an analysis of this case, see: AU, 'Insolvency: Valuation Evidence' (2015) 35(7) P.L.B. 51. See also: *Platts v Western Trust and Savings ltd* [1996] BPIR 399 CA, 347G.

[121] *Bluebrook* (n 110) obtained valuations based on three different methodologies: (1) an income based approach indicating business realisation proceeds based on the cash flow that the business could be expected to generate in the future (DCF method); (2) a market based approach indicating business realisation proceeds based on a comparison of IMO (UK) Limited to comparable publicly traded companies and an analysis of statistics derived from transactions in its industry (CCM method); and (3) a leveraged buy-out analysis based on the level of equity investment which a private equity investor could be prepared to make given a typical required equity rate of return in the current market (LBO method). See Ellis and Dusic (n 119) (comparing the alternative valuation methodologies proposed in the case and considering if mezzanine lenders had standing to challenge the scheme by virtue of having an economic interest in the company).

[122] Allen & Overy, 'IMO Scheme Leaves Mezzanine Creditors out in the Cold' (2009) 3(6) L. & F.M.R. 553; M Doran and M Singh, 'Difficult Times for Junior Creditors: IMO Car Wash and Other Recent Developments' (2010) 3(2) Bank. Law. 4.

Other methods include income-based valuation techniques such as discounted cash-flow ('DCF'). The DCF technique determines the intrinsic value of the company based on its earning capacity on the basis of a valuation carried out by an all-knowing analyst.[123] The DCF approach calculates the enterprise value by discounting the debtor's projected cash flows to a present day rate using the relevant cost of capital.[124] The discount is intended to reflect 'all risks of ownership and the associated risks of realising the stream of projected future cash flows'.[125] Discount is also intended to recognise that a pound received in a year from now is not equivalent in value to a pound received today.[126] In most DCF valuations, the projected cash flow is discounted by its Weighted Average Cost of Capital ('WACC')[127] using the debtor's projected earnings before interest, taxes, depreciation and amortisation ('EBITDA').

The DCF approach produces what are regarded as accurate results for companies that are stable and with predictable cash flows.[128] It requires the active involvement of the management of the distressed firm, who should produce a meaningful financial forecast for the period of three up to five years after restructuring.[129]

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[123] Sontchi (n 106) 6.
[124] PV Pantaleo and BW Ridings, 'Reorganization Value' (1996) 51 Bus. Law. 419, 427; O'Rourke (n 106) 421; Gilhuly and others (n 104) 59; Smith and King (n 116) 21.
[125] Purcell (n 116) 20.
[126] O'Rourke (n 106) 421.
[127] This represents the return that an investor would demand based on the company's debt-to-equity ratio.
[128] Lopez and others (n 106) 309.
[129] Smith and King (n 116) 21.

If procedural safeguards are put into place, DCF techniques appear more promising than AV methods to achieve the enhanced, procedural and substantive notion of fairness advocated by this paper because they include an element of futurity in the valuation process. However, slight changes to estimated cash flows and discount rates may lead to markedly dissimilar valuations. Valuers may have very different views on the future trend of the market. This, as a result, may have an impact on the expected cash flow and discount rate of the company and, therefore, the recommended valuation price. This, in turn, affects the predictability and replicability of DCF methods,[130] thus questioning its procedural fairness.

Other approaches are possible. These include the 'market comparison' or comparable companies multiple ('CCM') method, a technique which derives the debtor's value from market-assigned enterprise values, usually the earnings' potential of its competitors.[131] While each firm is unique, and perfect comparators do not exist, some companies are sufficiently close to carry out a market comparison. The more similar two companies are, the more this method can be used.[132]

The challenging aspects of CCM techniques are their reliance on profitable (preferably public) companies as terms of comparison and on the current economic environment, the flexibility in deciding which of the debtor's performance metrics should be considered and the need to reply on limitedly available financial

[130] Gilhuly and others (n 104) 59.
[131] *Re Mirant Corp.*, 334 B.R. 800, 837-838 (Bankr. N.D. Tex. 2005); Gilhuly and others (n 104) 59.
[132] Sontchi (n 106) 11.

information. With reference to performance metrics, it has been observed that they are not only sector-specific but also firm-specific, as the capital structure of a firm as well as its business model may significantly affect the comparability of otherwise similar businesses.[133]

In order to create meaningful insolvency scenarios, any result should be discounted to reflect the impact of distress and risk associated with a distressed or insolvent business,[134] thus often leading to strong disagreements amongst stakeholders. As a result, CCM methods have the potential of ensuring substantive, but not procedural fairness and they work for a limited range of companies, primarily public, profitable ones. Public companies represent a tiny portion of all companies and profitable ones usually do not file for insolvency procedures.

Another approach familiar to English courts is the comparable transaction multiple ('CTM') method. This is a market-based technique which derives the debtor's value from the price paid by purchasers for comparable companies or assets through a public merger or acquisition.[135] For this method, the price paid for the acquired company is related to its financial results, thus yielding implied transaction multiples.

CTM methods work preferably when they involve target companies that offer operational and economic comparability with the debtor and for transactions

[133] Hemming (n 109) 23.
[134] Smith and King (n 116) 21.
[135] O'Rourke (n 106) 420; Sontchi (n 106); Gilhuly and others (n 104) 59; Lopez and others (n 106) 307-312; Ayotte and Morrison (n 106) 1826-1831.

conducted within a reasonable time from the valuation date.[136] While finding transactions that are truly comparable is extremely challenging, this is the method that, so far, strikes the best balance between procedural and substantive issues of fairness.

CTM methods are replicable. Their reliance on objective standards facilitates their understanding and potential challenges from third parties. Finally, reliance on operational and economically comparable companies should ensure a tailored valuation of the debtor's assets and business.

It is also possible to adopt a market capitalisation ('MC') method, which is premised on the efficient capital market hypothesis.[137] Alternatively, valuations can be conducted pursuant to the leveraged buy-out ('LBO') method, whereby the current value of a business is based on achieving a target return at exit over a pre-determined period of time (three to five years) following the acquisition (or the approval of the rescue plan).[138] Both the MC and LBO methods rely on meaningful cash flow forecasts, which are hard to determine in insolvency scenarios. As a result, from a fairness standpoint, they suffer from the same shortcomings evidenced with reference to DCF methods: they lack predictability and replicability, thus affecting the alleged procedural fairness of the valuation method.

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[136] Purcell (n 116) 20.

[137] Gilhuly and others (n 104) 60. For an implementation of the MC method, see: *VFB LLC v Campbell Soup Co.*, 482 F.3d 624, 633 (3d Cir. 2007); *US Bank Nat'l Ass'n v Verizon Communications, Inc.*, Case No. 10-CV-1842-G (N.D. Tex. Jan 22, 2013).

[138] Smith and King (n 116) 21.

Compared to income-based approaches, market-based techniques suffer from a common deficiency. Markets, especially those for distressed businesses, are often imperfect for a variety of reasons, including illiquidity, incomplete or asymmetric information among investors, strategic behaviour, etc.[139] Adjustments are always needed.

To overcome this limitation, it may be promising to look at one of the most commonly accepted valuation techniques in insolvency cases, i.e. the liquidation method ('LM'). This technique focuses on the value of the assets of the company, rather than on its underlying business, determined on the basis of a price that would be paid in a "forced, fire sale" of the assets.[140] Unlike AV methods, in LMs the emphasis shifts to the items on the balance sheet of the debtor. The liquidation value is not the price that an informed party would pay for the assets in a perfect market, but the *real* price that a bidder would pay under existing market conditions and after having considered the distressed status of the debtor.

This method is frequently employed as a starting point for any discussion on the value of the debtor and the outcome of the insolvency procedure. It is not without faults either, as valuation of assets can be extremely controversial, especially in cases

[139] O'Rourke (n 106) 416.
[140] Crystal and Mokal (n 84) 64.

of intangible assets or of assets subject to securities and quasi-securities (such as retention of title clauses).[141]

Procedural fairness can be ensured if LMs are employed when the assets of the company are worth more than the on-going enterprise. However, no safeguards are put into place to ensure substantive fairness of outcomes. Finally, significant fairness and equality issues arise if LMs are employed to measure assets and business of a company which are worth more when sold as a going concern. AV methods have the potential to capture going concern values in every scenario, while LMs do not. As a result, LMs are probably the least attractive method from an enhanced fairness perspective.

Finally, sophisticated firms that possess hard-to-value assets (such as intangibles) are increasingly resorting to contractual valuation mechanisms ('CVM') to resolve anticipated valuation disputes.[142] With CVMs, clauses in corporate documents require that valuation disputes are referred to independent valuers, who will have to appraise the company on the basis of pre-determined algorithms. While these valuations are not binding for the parties in a corporate insolvency procedure, they still have evidentiary value.[143] Due to the highly discretionary nature of this method, it is not possible to state in general terms the extent to which it complies with the

[141] Against, Smith and King (n 116) 21 (arguing that 'asset based valuations […] are less frequently contested by financial creditors').
[142] Sharfman (n 106) 54-55.
[143] For a summary of the methods that can be used to measure the company's assets, see: Purcell (n 116).

enhanced definition of fairness offered in this paper. The assessment needs to be carried out on a case-by-case basis.

IV. CONCLUSION

This paper did not consider utilitarian and law and economics perspectives because English law pursues not only utilitarian, but also social justice goals. The revised communitarian, fairness-oriented framework adopted in this paper considers both utilitarian and social justice goals.

This paper investigated the structural components of the notion of fairness. The main purposes of this paper were to: (i) determine the elements needed to fairly measure value; and (ii) assess if the existing valuation techniques achieve a fair measurement of value in English insolvency and bankruptcy cases.

The author developed a specific framework to measure whether assets and businesses are fairly valued in insolvency and bankruptcy cases. This framework is based on a modified version of Rawls, Finch and Radin's concepts of fairness. Under this framework, fairness is understood as a substantive and procedural concept.

It is submitted that procedural fairness is the propensity of the system to rely on replicable and competitive techniques to value assets and to allow interested parties to challenge decisions taken in the course of insolvency procedures. Substantive fairness is the propensity of the system to adjudicate in favour of the parties who

have a lawful interest under the law whenever valuation decisions do not take into reasonable account the best interests of the parties concerned, the peculiarities of the valued assets, business or the market, the claimant-defendant relationship into reasonable account or do not treat similar situations alike.

When assessed against the fairness standard adopted in this paper, no valuation technique is without limitations, even if some (CCM and particularly CTM methods) appear more promising than others (LMs). Depending on the circumstances of the case, certain valuation methodologies may be weighted or eliminated completely as inappropriate.[144] Additionally, financial experts rightly suggest that good valuations are not based upon the use of a single technique, but on the triangulation of results obtained from various, sound methods.[145] In any case, the most reliable method to be employed in any given valuation depends on the circumstances of the case.[146]

This original finding raises significant policy issues. The parties involved in a formal insolvency or bankruptcy procedure cannot be allowed to maximise their returns and prioritise their interests at the expense of those of equally or higher-ranking creditors. As a result, these parties have a legitimate expectation of being treated fairly. What happens if – as this paper suggests – fairness cannot be achieved by the use of traditional valuation techniques? The answer given by this paper is that

[144] Purcell (n 116) 17.
[145] Wilton (n 103) 229.
[146] I Shaked and B Orelowitz, 'Case Studies in Corporate Bankruptcy Valuation' (2012) 31 Am. Bankr. Inst. J. 24; Lopez and others (n 106) 307.

regulatory reforms are needed to improve fair measurement of value in insolvency and bankruptcy procedures.

What is left to investigate is if, despite the absence of binding regulatory guidance, English courts have adopted consistent approaches to assess the fair market value of the debtor's business and its assets, and whether these approaches ensure fair valuations and protect the interested parties from unfair harm. This investigation is carried out in the second part of this study on valuations in English insolvency and bankruptcy cases. The findings of this investigation are published in a separate issue of this journal.[147]

[147] Vaccari (n 1).